PsiNaptic

2006 ANNUAL REPORT

TABLE OF CONTENTS

PsiNaptic is a technology company that develops and markets middleware software based on open standards to address the growing need to connect small, low-power wired or wireless devices without human intervention, configuration or set up.

Our Company is driven by the need to reduce complexity in computing networking, and to improve the human experience regarding data consumption in a mobile world. Our vision of the world is one in which billions of small embedded devices, all offering services and information, are connected to a network – a world where mobile devices such as cell phones and PDAs communicate with these and other devices to consume services and information with minimum human intervention. Management believes that PsiNaptic's technology and products play an important role in enabling this seamless communication between mobile and embedded devices.

PsiNaptic solutions operate on multiple platforms, across various networks and in all environments. With PsiNaptic's small-footprint adaptive networking technologies, networks of intelligent objects – from servers to embedded processors and Bluetooth® chips – can dynamically exchange information and services where and when needed, on a single protocol, independent of how the underlying hardware or software is configured and/or managed.

PsiNaptic software products JMatos and CMatos are commercially available. Both add dynamic networking capabilities to Java and non-Java embedded processors, revolutionizing the way devices interact. PsiNaptic software solutions are less than 100k standards-based Java/Jini software which can discover any application, driver or 'service' and move Java byte code between wired or wireless devices.

PsiNaptic's products are particularly applicable to companies developing solutions for handsets, vending machines, home automation, telematics, medical and other vertical markets.

Corporate Timeline

January 2000	PsiNaptic is founded in Calgary, Alberta, Canada
November 20, 2001	PsiNaptic launches its first product - JMatos® software for embedded devices - after clearing Sun Microsystems' tests
September 2, 2002	PsiNaptic launches CMatos, extending JMatos Jini technology capabilities to non-Java devices
June 17, 2003	Ford Motor Co. and PsiNaptic collaborate to bring Jini networking technology capabilities to the automotive industry
January 21, 2004	PsiNaptic completes its initial public offering
February 16, 2005	PsiNaptic raises $211,000 by way of private placement
May 26, 2005	PsiNaptic raises a further $415,500 by way of private placement
February 9, 2006	PsiNaptic raises $400,000 by way of private placement
March 13, 2006	PsiNaptic raises a further $300,000 by way of private placement

Letter to the Shareholders

The trend whereby an increasing number of manufacturers are introducing small edge-of-the-net devices which require local short-range device-to-device communication continued to accelerate in 2006 creating a demand for easy, user-friendly solutions. PsiNaptic concentrated its efforts and vigorously pursued customers in a number of market segments.

In the automotive segment, PsiNaptic significantly raised its profile with car manufacturers and tier one suppliers. We have successfully completed the integration of our technology with a major commercially available radio demonstrating the wireless interaction of a cellular phone containing MP3 music files with a car radio. This joint effort generated a great deal of interest among OEMs and we are working hard to convert that interest into sales. We are in the midst of two other similar projects with two additional tier one suppliers demonstrating the exchange of Navigation services between mobile devices and automotive on board systems.
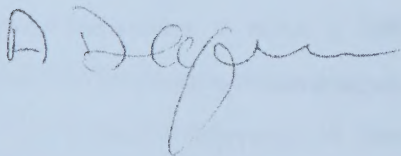
In the home automation market PsiNaptic continues to work closely with the world's largest home appliance manufacturer with an aim to add autonomous connective functionality to their next generation of smart appliances; we plan to complete the joint development in the first half of 2007. PsiNaptic continues to work closely with its licensee in the home automation market segment, and will record revenue in fiscal 07.

Also, we have increased our dialogue among utility companies and are working with the California Energy Commission on a proof of concept for a new approach on how to achieve energy savings in the home.

In addition to increasing activity in the automotive and home and industrial automation segments, PsiNaptic expanded its target markets and developed new opportunities in the machine-to-machine (M2M) segment. Three major industry manufacturers of fixed wireless modules for vending machines and asset management are assessing PsiNaptic middleware with the intent to produce proof of concepts.

The success of PsiNaptic is dependent on the demand for simplicity created by a society which is embracing technology at an ever increasing rate. We continue to believe that PsiNaptic's technology and products will play an important role in enabling this seamless communication between mobile and embedded devices.

Sincerely,

Aaron Dagan

President and Chief Executive Officer

Management's Discussion and Analysis

Prepared as of December 1, 2006

Highlights for the 2006 Fiscal Year

Financial Highlights

For the Years ended September 30	2006	2005
Revenue	$ -	$ 43,110
Net earnings (loss)	$ (787,189)	$ (736,638)
per share – basic	$ (0.0262)	$ (0.0348)
Cash flow from operations	$ (761,450)	$ (707,603)
Working capital	$ 222,711	$ 300,359
Total assets	$ 290,780	$ 382,285
Capital expenditures	$ 5,208	$ 4,077
Long-term debt	$ -	$ –
Shareholders' equity	$ 250,646	$ 339,314
Weighted average shares outstanding basic	30,075,031	21,177,086
Shares outstanding at period end	33,886,812	23,786,812

Operating Highlights

February 2005	PsiNaptic commences development on JCopia to address set-up boxes, internet modems, wireless modules and appliances in a home setting.
May 16 and 17, 2005	PsiNaptic presents workshop at Telematics Update, 2005, Detroit, Mi, USA
May 18 and 19, 2005	PsiNaptic participates at Wireless Connections 2005, Calgary, Ab., Canada
May 23 and 24, 2005	PsiNaptic participates at WiCon World, London, U.K.
August 2005	PsiNaptic commences development on an energy management program demonstration.
September 1, 2005	PsiNaptic presents at Automotive Consumer Electronics 2005 Conférence, Berlin, Germany
September 21, 2006	PsiNaptic and a major automotive tier one supplier collaborate to integrate mobile devices with car radios.
September 25, 2006	PsiNaptic makes JCopia software available for the remote management of IP (Internet protocol) connected devices.

Operations Review

JMATOS AND CMATOS SOFTWARE FOR MOBILE INFORMATION SERVICES

The concept of dynamic networking software to enable seamless interaction between devices as they move from environment to environment is of keen interest to companies looking for ubiquitous solutions to device interaction rather than proprietary solutions often requiring product specific cables, cradles and connectors.

This dynamic discovery and interaction between devices means that any mobile device can come into proximity of any wired or wireless, intelligent computing device and and interact with it, without having seen it before.

Examples are a mobile phone coming into proximity of a vending machine or entering into a vehicle or home. In each case, the mobile phone is able to "discover" and dynamically utilize the services intrinsic to each device/environment. The mobile phone can interact with the vending machine to dispense a ticket or product. In the vehicle, the mobile phone can discover and utilize the vehicles audio system, LCD screen or hands free system. Or upon entry into the vehicle, customize the vehicle to the users' preferences such as adjusting the seat, radio, telematic services etc.

In the home, a mobile phone can wirelessly discover and utilize "home services" such as audio, security, lighting or HVAC systems setting, the users' preferences for a radio station, security, lights or temperature.

PROLIFERATION OF BLUETOOTH, WIFI CAPABLE SMART PHONES

Many leading handheld manufacturers are interested in enabling their devices to interact with other devices locally (device–to-device), without accessing a website or server. Handheld manufacturers want their devices to multi-task and interact with many different types of devices such as parking meters, vending machines (or any point of sale machine (POS)), vehicle telematic platforms or other handheld devices. With more than 65% (in 2005) of all mobile phones sold in Western Europe being Bluetooth enabled, and half a billion phones expected to be Java enabled by year end 2005, consumers will be expecting their phones to be synchronized with more devices than just a headset, PC or PDA's.

There are many challenges to this vision. Pre-installing software for each service, each device and each model is simply not feasible. PsiNaptic software products JMatos and CMatos ensure that the device gets the relevant software only when it needs it. This allows a user to consume a service in an ad hoc manner without having to install and maintain specific software on their device. Currently the client software must be specifically written and installed for each type/kind/model of device, limiting its capability. JMatos/CMatos leverages the ability of Java and the JVM to 'write once run anywhere', by providing the actual software code required by the client. This software code (or Object) is loaded and instantiated on the client and run locally.

In the example above, both the mobile phone and POS machine are Bluetooth or WiFi enabled. The mobile phone has never "seen" the POS machine before, but the user wants to purchase a soft drink. The POS downloads its driver/attributes/graphical user interface (GUIs) as a Java Object to the mobile phone. The mobile phone loads and instantiates the object and now has all the information it needs to transact with the particular machine, making a selection and offering payment. When the user walks away from the machine, the byte code is removed, freeing up limited resources on the mobile phone.

PROVIDING CONTEXTUALLY RELEVANT INFORMATION AND SERVICES

As large volumes of Internet content become accessible to mobile devices and as new mobile-specific content emerges, it will become too overwhelming for users to manage all the available information and services. In the mobile Internet environment, the traditional web-based destination model will not be able to deliver compelling end user information and services. The greatest challenge for the mobile Internet is the management of a pervasive electronic presence to sense and respond to a customer's unique profile i.e. who they are, what they need, and their information and service preferences.

JMatos-and CMatos-enabled devices can access network services where and when needed, and do so without the need for complicated user intervention. Information devices are closely associated with their users and hence, move with them throughout the day. That means moving from network to network, whether the network is a Personal Area Network (PAN), Local Area Network (LAN) or Wide Area Network (WAN). In addition, these networks are set in varied contexts, from the home to the mall, schools and the office. The nature of the information and services needed is as varied as the environments. With JMatos and CMatos technology, information and services can be provided to the device in a context-sensitive manner, used as needed and then discarded as the user changes context. Memory and resource-constrained devices can now offer more and varied services without a corresponding increase in memory and processing power. Increasing the functionality of devices and enabling new context-sensitive services allows differentiation among service providers, increased revenues and reduced churn.

JMatos and CMatos software offers a number of benefits for Original Equipment Manufacturers (OEMs), application developers, service providers and end users.

1. Provides a mechanism for enabling a pervasive electronic presence that senses and responds to a customer-unique profile, allowing mobile users to automatically receive context-relevant services in a seamless manner across different networks (WAN, LAN and PAN).

2. Solves the interoperability and ease-of-use issues that currently exist with Bluetooth and other short-range communications technologies, thus supporting the deployment of compelling PAN services.

3. Allows applications to run in a seamless manner across mobile devices and other Java-enabled devices (i.e. POS terminals, TV set-top boxes, desktop PCs, etc.).

4. Enables automatic configuration of applications on mobile devices.

5. Enables automatic updates to applications on mobile devices. Jini technology can provide a non-proprietary mechanism to allow mobile device applications to integrate seamlessly into service provider and enterprise IT infrastructures.

As with any other technology development, the true potential of this technology can only be realized through effective partnerships and alliances between manufacturers, systems and service providers across the mobile industry.

USING DYNAMIC NETWORKING SOFTWARE TO INTEGRATE MOBILE DEVICES INTO THE VEHICLE

There is a keen interest by vehicle manufacturers and Tier 1 suppliers to find software solutions to integrate consumer electronic and mobile devices in their vehicles. Many are beginning to realize the impracticality of proprietary solutions involving product-specific cables, cradles and connectors that are restrictive and have short life spans. Even Bluetooth and its plethora of profiles are a deterrent to addressing the gap between consumer device and vehicle life cycles.

PsiNaptic's software technology has been gaining traction with OEMs telematic platforms looking for solutions to:

a. Enable the seamless discovery and integration of mobile devices into the vehicle (mobile phone, MP3 Player, medical device, game player or PDA). Controlling mobile devices coming into the vehicle and potentially linking them to back-end e-business infrastructure - allowing anytime, anyplace access to information/services.

b. Enable vehicle centric information (i.e. diagnostics) to be accessed/shared by the user or service station

c. Enable the vehicle to e-transact etc... From back-office to the automobile platform to enable installing or un-installing bundles.

Key benefits for vehicle makers are positively impacting the user experience and enabling the vehicle platform to accept future revisions.

JMATOS/CMATOS CREATE NEW BUSINESS OPPORTUNITIES IN THE MACHINE-TO-MACHINE (M2M) MARKETPLACE

M2M is a buzzword used to designate the concept of communications between a device containing some amount of data and another device that requires the use of that data. M2M is commonly translated as machine-to-machine or man-to-machine. The most common implementation of M2M is through telemetry systems. Once the exclusive domain of large oil and gas companies and electric utilities using extensive custom built dedicated data networks, telemetry has become more accessible with the advancement of wireless cellular technologies. This accessibility is the core of M2M.

M2M solutions are used by different organizations across multiple industries. For instance, utility providers use M2M solutions to conduct remote readings of electricity, water and gas meters, saving time and reducing the cost of taking the readings manually. Logistics operators use the M2M platform as a fleet management system, for asset tracking, security, wireless vending, and exception reporting and wireless point-of-sale terminal applications.

PsiNaptic is experiencing a surge of interest in JMatos and CMatos from software architects at utility companies, interested in energy management applications and fixed wireless modules manufacturers, looking for opportunities to increase revenues with micro-commerce applications.

The key benefit for utility companies is the ability to streamline power consumption such that peak periods are avoided. At the heart of energy management systems is a self deploying intelligent meter that connects automatically with both the distributor and smart appliances in the home. As a result utility companies can operate their grid systems more efficiently, lower their capital investments and reduce service failures.

By 2015, micro-commerce (a purchase valued at less than $5 or 5 Euros and conducted electronically) opportunities for new products and services will generate between $60 and $240 billion in revenue per year (Gartner Inc. Research Note November 1, 2004). Fixed wireless module manufacturers are looking to find a way to move software code dynamically between small devices. Many are realizing the need for local machine-to-machine communication, as opposed to all M2M interaction being web based. For example, the more mobile devices interacting with fixed POS machines, the more data will need to be exchanged between the POS machine and a back end server across a wireless network.

All players in the value chain stand to gain from enabling mobile phones to make local e-payments with wireless vending machine:

Wireless carrier: can increase network traffic

Wireless module manufacturer: can charge more for added functionality

POS provider: can charge more for the convenience of making an e-purchase

Infrastructure/application provider user: can use their mobile device to make payments

PSINAPTIC PRODUCTS

JMatos®

JMatos is an implementation of the Jini Lookup Service and related protocols that enable very small, embedded processors to offer Java-based services. Fully Jini Network Technology compliant, JMatos' less than 100KB footprint enables resource-constrained devices to find each other and spontaneously offer or consume services on a network.

JMatos extends Jini Network functionality to devices on the edge of the net, making possible an end-to-end pervasive computing solution based on an open standard protocol.

CMatos

Fully Jini Network Technology compliant, CMatos' less than 60KB footprint lookup and discovery protocol enables resource constrained devices to find each other, interconnect and spontaneously offer or consume services on a network or any computing device that acts as a Jini client.

CMatos extends the reach of Java into non-Java devices and enables legacy devices to become Jini network capable. CMatos is available in even smaller footprints for devices that do not need to register external services.

JCopia

In 2005, PsiNaptic commenced development on JCopia to address data and entertainment transmission in the home arena. Devices such as a set-up boxes or appliances brought into the home will auto deploy, find a network, and download initial services such as digital content or an intelligent meter. Automatic updates are managed by JCopia to load, swap and discard services or applications autonomously and efficiently.

Financial Statement Discussion and Analysis

This discussion and analysis should be read in conjunction with the audited financial statements of PsiNaptic Inc. ("PsiNaptic" or "the Corporation") as of September 30, 2006. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

FORWARD – LOOKING STATEMENTS

The Management's discussion and analysis contains forward-looking statements, including the Corporation's expectations as to the success of its research and development programs related to JMatos® and CMatos, which involve known and unknown risks and uncertainties, and which could cause the Corporation's actual results to differ materially from those in the forward-looking statements. Such risks and uncertainties include, among others, the availability of funds and resources to successfully commercialize JMatos® and CMatos and general changes to the economic environment. Investors are cautioned against placing undue reliance on forward-looking statements. The Corporation does not undertake to update these forward-looking statements.

Comparison of the years ended September 30, 2006 and 2005

HIGHLIGHTS

PsiNaptic markets energy management demonstration program.

PsiNaptic and a major automotive tier one supplier collaborate to integrate mobile devices with car radios.

PsiNaptic makes JCopia software available for the remote management of IP (Internet protocol) connected devices.

RESULTS OF OPERATIONS

PsiNaptic incurred an operating loss of $798,571 in the year ended September 30, 2006, which compares to an operating loss of $744,025 in the year ended September 30, 2005. The net loss, after expense recoveries and interest, was $787,189 for the year ended September 30, 2006 compared to net loss of $736,638 for the year ended September 30, 2005.

OPERATING EXPENSES

Total operating expenses increased to $798,571 in the year ended September 30, 2006 from $787,135 in the year ended September 30, 2005. Salaries, including consultants, and benefits were $458,600 in the year ended September 30, 2006 compared to $458,485 in the year ended September 30, 2005. Other general and administrative costs increased to $239,914 in the year ended September 30, 2006 from $183,004 in the year ended September 30, 2005. This increase is primarily due to PsiNaptic expending $42,234 in the current year as a result of legal costs incurred in an attempt to enforce payment due under one of its licensing contracts. No revenues have been recognized as the outcome is uncertain.

Other marketing expenses decreased to $76,953 in the year ended September 30, 2006 from $109,675 in the year ended September 30, 2005, reflecting decreased promotional fees at conferences in North America. PsiNaptic continues to market its software in England, France, Germany, Israel and the United States.

RECOVERIES AND OTHER INCOME

PsiNaptic has not generated any licensing revenue in the current period whereas it generated $17,856 on account of initial licensing fees for the year ended September 30, 2005.

In addition, PsiNaptic has not recorded any consulting revenue in the current period whereas it recorded consulting revenue of $25,254 for the year ended September 30, 2005.

PsiNaptic earned net interest income from its short-term investments of $11,382 in the year ended September 30, 2006 compared to $7,387 in the year ended September 30, 2005.

FINANCIAL CONDITION

Funds used in operations were $761,450 in the year ended September 30, 2006, compared to $707,603 used in the year ended September 30, 2005.

Financing activities during the year ended September 30, 2006 resulted in gross proceeds of $700,000 - $400,000 from the private placement of 8,000,000 Class A common shares at $0.05 (net proceeds, after financing costs of $17,430 were $382,570) and $300,000 from the private placement of 2,000,000 Class A common shares at $0.15 (net proceeds, after financing costs of $4,728 were $295,272).

Financing activities during the year ended September 30, 2005 resulted in gross proceeds of $626,000 - in February 2005, PsiNaptic issued 2,110,000 common shares at a price of $0.10 for gross proceeds of $211,000 and in May 2005, PsiNaptic issued an aggregate of 2,770,000 units at a price of $0.15 per unit for gross proceeds of $415,500. Each unit comprised one common share and one-half of one share purchase warrant. Each whole warrant entitles the holder to acquire one common share at a price of $0.25 per share for a period ending two years from date of issuance.

Investing activities during the years ended September 30, 2006 and 2005 consisted of the investment of funds from the proceeds of its financing activities in excess of its immediate needs.

Also during the year ended September 30, 2006, the Company expended $5,208 on capital assets compared to $4,077 in the year ended September 30, 2005.

Comparison of the three months ended September 30, 2006 and 2005

HIGHLIGHTS

On September 21, 2006 PsiNaptic announced that it collaborated with a major automotive tier one supplier to successfully integrate mobile devices with car radios.

On September 25, 2006 PsiNaptic announced that JCopia software is now available for the remote management of IP (Internet Protocol) connected devices.

RESULTS OF OPERATIONS

PsiNaptic incurred an operating loss of $205,092 in the quarter ended September 30, 2006, which compares to an operating loss of $204,380 in the quarter ended September 30, 2005. The net loss, after expense recoveries and interest, was $202,020 for the quarter ended September 30, 2006 compared to net loss of $202,141 for the quarter ended September 30, 2005.

OPERATING EXPENSES

Total operating expenses remained stable at $205,092 in the quarter ended September 30, 2006 compared to $204,661 in the quarter ended September 30, 2005. Salaries, including consultants, and benefits were $105,649 in the quarter ended September 30, 2006 compared to $120,817 in the quarter ended September 30, 2005. Other general and administrative costs increased to $72,222 in the quarter ended September 30, 2006 from $61,592 in the quarter ended September 30, 2005. This increase is primarily due to increased audit fees ($4,708), investor relation expenses ($3,351), and legal ($4,548).

Other marketing expenses increased to $22,032 in the quarter ended September 30, 2006 from $14,272 in the quarter ended September 30, 2005, primarily due to promotion and travel expenses.

RECOVERIES AND OTHER INCOME

PsiNaptic earned net interest income of $3,072 in the quarter ended September 30, 2006 compared to $2,239 in the quarter ended September 30, 2005.

FINANCIAL CONDITION

Funds used in operations were $184,279 in the quarter ended September 30, 2006, compared to $194,610 in the quarter ended September 30, 2005.

Investing activities during the quarters ended September 30, 2006 and 2005 consisted of the redemption of funds originally invested from the proceeds of the private placements in excess of its immediate needs.

SINCE PsiNaptic's inception, the Company has not engaged in any off-balance sheet financial arrangements, or in any financial instruments and other instruments which might be settled by delivery of non-financial assets.

DURING fiscal 2006 and 2005, the Company has not engaged in any transactions with related parties.

HISTORICAL FINANCIAL INFORMATION

	Total Assets	Net Loss	Loss Per Share
Year ended September 30, 2004	$ 496,408	$ 774,877	$ 0.0451
Quarters ended:			
December 31, 2004		$ 145,589	$ 0.0077
March 31, 2005		$ 182,554	$ 0.0092
June 30, 2005		$ 206,354	$ 0.0093
September 30, 2005		$ 202,141	$ 0.0084
Year ended, September 30, 2005	$ 382,285	$ 736,638	$ 0.0348
Quarters ended:			
December 31, 2005		$ 181,455	$ 0.0076
March 31, 2006		$ 170,491	$ 0.0059
June 30, 2006		$ 233,223	$ 0.0083
September 30, 2006		$ 202,020	$ 0.0060
Year ended September 30, 2006	$290,780	$787,189	$ 0.0262

During fiscal 2006, the level of operations remained similar to 2005.

LIQUIDITY AND CAPITAL RESOURCES

The Corporation expected its licensing agreements to generate licensing fees during the current year. Fees from the first license have been delayed to 2007 and the second license has been cancelled by the license holder. At this time, the company is unable to determine when it might receive significant licensing fees.

Until PsiNaptic is able to achieve substantial revenues or profitability over several quarters, the Company remains dependent on selling its equity securities to fund its capital requirements and ongoing operations; however, there can be no assurance the Company will be successful in these efforts.

PsiNaptic ended its 2006 fiscal year with working capital of $222,711. PsiNaptic is taking steps to further reduce its expenses and maximize the use of its available funds. Without further equity, the Company anticipates utilizing its present working capital by March 31, 2007.

ADDITIONAL INFORMATION

Additional information relating to PsiNaptic can be located on SEDAR at www.sedar.com.

Management's Responsibility for Financial Statements

The accompanying audited financial statements and all of the information included in this annual report have been prepared by and are the responsibility of management and have been recommended by the audit committee for approval by the Board of Directors. The annual financial statements have been prepared in accordance with generally accepted accounting principles and reflect management's best estimates and judgements based on current information. The significant accounting policies which management believes are appropriate for the Company are described in Note 3 of the annual financial statements.

The Company has developed and maintains an appropriate system for internal controls in order to ensure, on a reasonable and cost-effective basis, that relevant and reliable financial information is produced.

The Audit Committee is appointed by the Board and consists of two independent Directors and the President. To discharge its duties the Audit Committee meets regularly with management and Deloitte & Touche LLP to discuss internal controls, accounting and financial reporting processes, audit plans and financial matters.

Deloitte & Touche LLP is responsible for auditing the financial statements and expressing their opinion thereon and their report is presented separately. The external auditors have full and free access to meet with management, the Audit Committee and the independent members thereof.

Aaron Dagan   Morris Bleviss

President and Chief Executive Officer   Chief Financial Officer

December 1, 2006

Auditors' Report

To the Shareholders of PsiNaptic Inc.:

We have audited the balance sheets of PsiNaptic Inc. as at September 30, 2006 and 2005 and the statements of loss and deficit and cash flows for the years ended September 30, 2006 and 2005 and cumulative from inception on December 16, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2006 and 2005 and the results of its operations and its cash flows for the years ended September 30, 2006 and 2005 and cumulative from inception on December 16, 1999 in accordance with Canadian generally accepted accounting principles.

DELOITTE & TOUCHE LLP   Chartered Accountants
Calgary, Alberta   October 20, 2006

Statements of Loss and Deficit

Years Ended September 30, 2006 and 2005 and Cumulative From Inception on December 16, 1999

	September 30, 2006 $	September 30, 2005 $	Cumulative From Inception on December 16, 1999 $
REVENUES			
Licensing	-	17,856	17,856
Consulting	-	25,254	43,659
	-	43,110	61,515
EXPENSES			
Depreciation and amortization	17,309	23,342	270,249
General and administrative	387,695	312,851	2,053,661
Marketing	252,950	279,863	1,634,279
Research and consulting	140,617	171,079	2,172,365
	798,571	787,135	6,130,554
LOSS BEFORE OTHER INCOME	(798,571)	(744,025)	(6,069,039)
OTHER INCOME			
Interest income	11,382	7,387	120,768
IRAP expense recovery	-	-	211,197
SRED tax credits	-	-	620,152
	11,382	7,387	952,117
NET LOSS	(787,189)	(736,638)	(5,116,922)
DEFICIT, BEGINNING OF YEAR	(4,329,733)	(3,593,095)	-
DEFICIT, END OF YEAR	(5,116,922)	(4,329,733)	(5,116,922)
LOSS PER SHARE (Note 9)	(0.0262)	(0.0348)	-

PSINAPTIC INC.

Balance Sheets
As at September 30, 2006 and 2005

	2006 $	2005 $
ASSETS		
CURRENT		
Cash	**13,909**	13,188
Short-term investments	**229,969**	310,587
Accounts receivable	**3,472**	4,426
Prepaid expenses	**15,495**	15,129
	262,845	343,330
Capital assets (Note 4)	**25,648**	30,814
Intellectual property (Note 5)	**2,287**	8,141
	290,780	382,285
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	**40,134**	42,971
SHAREHOLDERS' EQUITY		
Share capital (Note 6)		
Common Shares	**5,266,256**	4,578,414
Contributed Surplus	**101,312**	90,633
	5,367,568	4,669,047
Deficit	**(5,116,922)**	(4,329,733)
	250,646	339,314
	290,780	382,285

APPROVED ON BEHALF OF THE BOARD

"Stuart M. Olley"
. . . . **Director**

"Aaron Dagan"
. ... **Director**

PSINAPTIC INC.

Statements of Cash Flows
Years Ended September 30, 2006 and 2005

	September 30, 2006 $	September 30, 2005 $	Cumulative From Inception on December 16, 1999 $
OPERATING			
Net Loss	**(787,189)**	(736,638)	(5,116,922)
Adjustments for:			
Depreciation and amortization	**17,309**	23,342	270,249
Non-cash marketing expense	**-**	-	100,000
Stock-based compensation	**10,679**	1,524	12,563
	(759,201)	(711,772)	(4,734,110)
Changes in non-cash working capital:			
Accounts receivable	**954**	(299)	(3,472)
Prepaid expenses	**(366)**	(1,944)	(15,495)
Accounts payable and accrued liabilities	**(2,837)**	(6,412)	40,134
	(761,450)	(707,603)	(4,712,943)
INVESTING			
(Purchase) redemption of short-term investments	**80,618**	88,081	(229,971)
Purchase of capital assets	**(5,208)**	(4,077)	(242,481)
Protection of intellectual property	**(1,081)**	-	(74,220)
SRED recovery on capital assets	**-**	-	18,518
	74,329	84,004	(528,154)
FINANCING			
Issuance of shares, net of expenses	**687,842**	614,579	3,242,176
Issuance of warrants, net of expenses	**-**	-	2,012,830
	687,842	614,579	5,255,006
NET (DECREASE) INCREASE IN CASH	**721**	(9,020)	13,909
CASH, BEGINNING OF YEAR	**13,188**	22,208	-
CASH, END OF YEAR	**13,909**	13,188	13,909

Notes to the Financial Statements
Years Ended September 30, 2006 and 2005

1. **BASIS OF PRESENTATION AND GOING CONCERN ASSUMPTION**

These financial statements have been prepared using the going concern assumption, which contemplates that PsiNaptic Inc. ("the Company") will be able to realize its assets and discharge its liabilities in the normal course of business. At September 30, 2006, there are certain aspects of the Company's financial position, which cast doubt on the use of the going concern assumption, including a deficit of $5,116,922 and a net loss of $787,189 for the year ended September 30, 2006.

The ability of the Company to continue as a going concern is dependant upon achieving profitable operations and obtaining additional financing to develop, market and manufacture its products and services. If the Company does not achieve profitable operations or obtain additional financing, the use of the going concern assumption may not be appropriate.

Management expects the cash balance will be fully utilized in March 2007 and is presently pursuing additional public and private sources of financing. Although the licensing agreement in place provides for certain minimum licensing revenue commencing in mid 2007, these revenues will be insufficient to maintain the present level of operating expenditures. The Company can give no assurances that it will be successful in executing this plan. Should it fail to raise sufficient capital or earn additional revenue it may be forced to suspend it's operations and possibly liquidate it's assets, wind-up and dissolve the company.

If the going concern assumption is not appropriate, then adjustments may be necessary to the carrying values of the assets and liabilities, the reported net loss and the balance sheet classifications used, and these adjustments may be material.

2. **NATURE OF OPERATIONS**

The Company was incorporated on December 16, 1999 under the Business Corporations Act (Alberta) as 858393 Alberta Inc. On January 6, 2000, the Company changed its name to PsiNaptic Communications Inc. On May 1, 2001, the Company changed its name to PsiNaptic Inc. To date, the Company has not earned significant revenues and is considered to be in the development stage. The Company's focus has been research and development of deeply embedded wireless Java modules. These devices are intended for use in wireless distributed computing environments and are targeted for sale to original equipment manufacturers.

3. **SIGNIFICANT ACCOUNTING POLICIES**

Cash

Cash includes cash on hand, balances with banks.

Short-term investments

Short-term investments are short-term deposits with a maturity of less than 90 days from the date of purchase and are valued at the lower of cost and market value.

Deferred financing costs

Deferred financing costs represent costs related to the initial public offering (Note 6) and were recorded as a reduction of the proceeds from the initial public offering upon completion of the transaction.

Capital assets

Capital assets are recorded at cost and are depreciated over their useful lives, from the month of acquisition, using the declining-balance method at the following annual rates:

Office furniture	20%
Tools and equipment	30%
Computer hardware	30%
Computer software	30% to 100%
Development tools	100%

Intellectual property

Intellectual property consists of patents and trademarks, which are recorded at cost and amortized on a straight-line basis over their useful lives, from the month of acquisition. The estimated useful life of the intellectual property is four years.

Research and development costs

Research costs are expensed as incurred. The costs of developing new products are capitalized as deferred development costs if they meet the Canadian Institute of Chartered Accountant's ("CICA") development capitalization criteria related to technical, financial and market feasibility. To date, all of the development costs have been expensed as all of the criteria for deferral has not yet been met.

Scientific research and experimental development investment tax credits (SRED)

Scientific research and experimental development investment tax credits are accounted for using the income approach and are recorded upon receipt of the credit. Credits are recorded as either a reduction of the cost of applicable assets or included in income depending on the nature of the expenditures that gave rise to the credits. With the completion of its initial public offering in 2004 the Company continues to qualify for SRED credits to apply against future taxes payable; however, the credits are no longer refundable.

Revenue recognition

The Company recognizes revenue when a licence agreement with the customer has been signed, the software product has been delivered, the amount of the fees to be paid by the customer is fixed and determinable, and collection of these fees is deemed probable. If collectability is not considered probable, revenue is recognized when the fee is collected.

The Company enters into software licence agreements that provide for future royalty/license payments to be made based on a per unit fee. These arrangements often specify a quarterly minimum payment. Revenue from the minimum payments is recognized on a straight-line basis. Revenue associated with unit fees in excess of any minimum payments is recognized when the amount becomes determinable, generally on a quarterly basis.

Future income taxes

Income taxes are accounted for using the liability method of income tax allocation. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and measured using the substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Stock based compensation

The Company has an incentive stock option plan as described in Note 6, which is administered by the Board of Directors and accounted for using the fair value based method, as defined by the CICA. The fair value method established the standards of recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services provided by employees and non-employees. Compensation expense is recognized on the fair value of the options as on the grant date and is amortized over the vesting life with an offsetting amount recorded in contributed surplus. Any consideration paid on exercise of stock options or purchase of stock is credited to share capital.

Financial instruments

The Company's financial instruments consist of short-term investments, accounts receivable and accounts payable and accrued liabilities. As at September 30, 2006, there are no material differences between the carrying values of these amounts and their fair market values due to the short-term nature of these financial instruments.

4. **CAPITAL ASSETS**

	Cost $	2006 Accumulated Depreciation $	Net Book Value $
Office furniture	17,953	12,451	**5,502**
Tools and equipment	52,021	44,523	**7,498**
Computer hardware	40,533	29,549	**10,984**
Computer software	11,667	10,580	**1,087**
Development tools	101,411	100,834	**577**
	223,585	197,937	**25,648**

	Cost $	2005 Accumulated Depreciation $	Net Book Value $
Office furniture	17,953	11,075	6,878
Tools and equipment	52,021	41,310	10,711
Computer hardware	36,358	25,411	10,947
Computer software	11,667	10,114	1,553
Development tools	100,758	100,033	725
	218,757	187,943	30,814

5. **INTELLECTUAL PROPERTY**

	Cost $	2006 Accumulated Amortization $	Net Book Value $
Patents and trademarks	57,759	55,472	**2,287**

	Cost $	2005 Accumulated Amortization $	Net Book Value $
Patents and trademarks	56,678	48,537	8,141

Amortization of $6,935 (2005 - $12,211) on the patents and trademarks is included in depreciation and amortization expense.

6. SHARE CAPITAL

	Number of Shares	Amount $
Authorized		
Unlimited number of Class A common voting shares		
Unlimited number of Class B common non-voting shares		
Unlimited number of Special Warrants, issuable in series		
Issued		
Common shares		
Class A common shares		
Balance, September 30, 2004	18,906,812	**3,963,835**
Private placement at $0.10 per share	2,110,000	**211,000**
Initial public offering at $0.15 per share	2,770,000	**415,500**
Less financing costs	-	**(11,921)**
Balance, September 30, 2005	23,786,812	**4,578,414**
Private placement at $0.05 per share	8,000,000	**400,000**
Private placement at $0.15 per share	2,000,000	**300,000**
Less financing costs		**(22,158)**
Options exercised at $0.10 per share	100,000	**10,000**
Balance, September 30, 2006	33,886,812	**5,266,256**
Contributed Surplus		
Balance, September 30, 2005	-	**90,633**
Stock based compensation	-	**10,679**
Balance, September 30, 2006	-	**101,312**
Total, September 30, 2005	23,786,812	**4,669,047**
Total, September 30, 2006	33,886,812	**5,367,568**

Private placement units

There are 1,385,000 common shares reserved for the exercise of private placement warrants issued in May 2005. Each whole private placement warrant is convertible into one common share at an exercise price of $0.25 per share for a period of two years from the date of issuance. The last closing under the private placement was May 26, 2005.

Stock options

On September 22, 2003, the Company cancelled the existing stock option plan and adopted a new stock option plan for directors, officers, employees and consultants who help achieve the long-term objectives of the Company. The Board of Directors administers the plan. Under this plan, the directors can specify the exercise price and vesting terms on an individual basis. Options granted under this plan cannot expire more than five years after being granted.

The total number of options outstanding under this plan cannot exceed 10% of the issued and outstanding common shares. The Company has reserved 3,388,681 common shares and has granted options to purchase 2,413,500 common shares at an average price of $0.24. In the event of resignation, retirement or termination, the optionee has 30 days to exercise the options.

During the year ended September 30, 2006 there were 1,000,000 options issued; 100,000 options were exercised and 100,000 options were forfeited. Details of options outstanding under the plan are as follows:

| Expiry | 2006 | | | |
	Number of Options	Exercise Price	Weighted Average Contractual Life (Years)	Number Exercisable
March 31, 2007	261,000	$0.75	.50	261,000
September 15, 2008	1,054,500	$0.25	1.95	1,054,500
November 21, 2008	40,000	$0.25	2.15	40,000
January 5, 2009	10,000	$0.37	2.27	10,000
June 14, 2010	88,000	$0.15	3.71	88,000
September 20, 2010	160,000	$0.10	3.98	120,000
January 31, 2011	800,000	$0.10	4.33	400,000
	2,413,500			1,973,500

| | 2006 | | 2005 | |
	Number Outstanding	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
Outstanding, beginning of year	1,613,500	$0.31	1,498,500	$0.37
Granted	1,000,000	$0.10	248,000	$0.10
Exercised	(100,000)	$0.10	-	-
Expired/forfeited	(100,000)	$0.10	(133,000)	$0.58
Outstanding, end of year	2,413,500	$0.24	1,613,500	$0.31

The Company has estimated the value of the options granted during the year using the Black-Scholes option pricing model. The value of the options granted during the second quarter was $0.10 per share based on the exercise price of $0.10 per share, a risk-free interest rate of 4.04%, an expected life of five years, and an expected volatility rate of 380%.

Based on the assumptions above, the Company recorded $10,679 (2002-$1,524) on account of stock-based compensation expense for the year ended September 30, 2006.

7. COMMITMENTS

The Company has entered into a lease agreement for office space. The aggregate rental payments, excluding operating costs, and services payments required are as follows:

2007	$ 18,000
2008	$ 2,000

8. INCOME TAXES

The Company has accumulated the following tax balances, the future benefit of which has not been reflected in these financial statements.

Non-capital losses of approximately $4,437,000 available for carryforward expire as follows:

	$
2007	847,000
2008	865,000
2009	294,000
2010	795,000
2014	792,000
2015	844,000

Investment tax credits of approximately $53,000 are available for carryforward and expire between 2011 and 2014.

Unclaimed scientific research and experimental development expenditures of approximately $672,000 carry forward indefinitely.

9.   **PER SHARE AMOUNTS**

Loss per share has been calculated using the weighted average number of Class A common shares outstanding during the year of 30,075,031 (2005 - 21,177,086).

Diluted loss per share is not disclosed in these financial statements as the exercise of the stock options is anti-dilutive.

10.   **CONTINGENCIES**

On December 9, 2005 the Corporation commenced legal action arising from the breach of a licensing agreement for $200,000 plus interest and court costs. The defendant has made a counterclaim for $400,000 for misrepresentations and breach of the same contract. Management believes the counterclaim is without merit. No amount with respect to either of these claims has been accrued in these financial statements as the outcome is not determinable.

Corporate Information

BOARD OF DIRECTORS

Aaron Dagan*
President & CEO
PsiNaptic Inc.

Stuart M. Olley*
Partner,
Stikeman Elliott LLP

Andrew L. Oppenheim
Partner,
Gowling Lafleur Henderson LLP

Stephen Eyre*
Principal Strategy Consultant
Microsoft Canada

MANAGEMENT TEAM

Aaron Dagan
President & CEO

Cameron Roe
Vice President and
Chief Software Architect

Serge Brache
Manager Product Development

Morris Bleviss
Chief Financial Officer

* member of Audit Committee

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SHAREHOLDER INFORMATION

For annual and quarterly reports, news releases and other investor information, please contact:

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STOCK EXCHANGE LISTING

TSX Venture Exchange

Trading Symbol: PST

PsiNaptic